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10. Abstract (optional - 250 word limit)

Indonesia has institutions providing small and microcredit and they handle considerable volumes of credit both in Indonesian and international perspective. The formal institutions are depositor based and self-sustaining. Further, though the institutions and the Small and Micro Enterprise (SME) sector itself have not escaped being affected by the Monetary Crisis, the effects are relatively mild as compared to those on the economy as a whole. The formal institutions for microcredit in Indonesia include the Unit Desa network of Bank Rakyat Indonesia (BRI), the Banks Perkreditan Rakyat (BPR) and various savings and loan cooperatives. The semiformal institutions are a vast variety of organizations that give loans and sometimes take deposits with government or NGO support. Each of these institutions serves a different market segment. Despite the volume of lending and variety of institutions, many Indonesian SMEs do not have access to financial services for which they would be willing to pay. The finance available is unevenly spread throughout the country and is concentrated in Java and Bali. Even when financial services reach SME their costs may be high. Many of the institutions have high administrative and loan loss costs.

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Small and Micro-Enterprise Finance in Indonesia: What Do We Know?

By Thomas A. Timberg, Partnership for Economic Growth, Small Scale Credit Advisor, Bank Indonesia, August 29, 1999[1]

In Theory

In this paper, we begin with some theory, continue with some findings, and conclude with some recommendations. Practical persons, to paraphrase Lord Keynes, should skip the first section, and really practical ones might skip the second one as well, and proceed to the third.

Theoretically it is not entirely clear why we are interested in Small and Micro-Enterprise (SME) finance. As the joke goes, it takes no economists to replace a broken bulb, because if it were broken the market would already have fixed it. Or as the late Professor Mancur Olson said, there cannot be a $100 bill accidentally laid on the ground because someone would have picked it up already.

Perfectly functioning factor markets would already have permitted the optimum size distribution of entrepreneurs, enabling them to optimally combine factors of production to produce the maximum possible product in the most efficient manner. We would get precisely the quantum of SME we want. That maximum possible product might be inequitably distributed from some value point of view, though any redistribution would reduce its total amount. By hypothesis, no economic externalities would exist. Actually, financial markets are accepted as requiring some regulation to produce their greatest value added, and more tentatively public intervention to promote the growth of production may have some merit either in the increasing the volume of production or the equity of its distribution or promoting social values incidentally connected with production. Thus countries undertake and analysts justify publicly supported programs of export promotion, they undertake transfer payments, and they ban certain otherwise profitable activities such as the production of narcotic drugs.[2] These government programs all have costs but we have decided that the benefits are greater than the costs and that government is the appropriate agent for seeking those benefits.

Public intervention to promote small and medium or small and micro-enterprise can be justified because:

- Production in general should be encouraged and much of it is done by SMEs.
- SMEs are unduly discriminated against because of their lack of social influence.
- SMEs have merits beyond those recognized by the market.

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[1] USAID-funded Partnership for Economic Growth (PEG) Project. The views expressed in this report are those of the author and not necessarily those of USAID, the U.S. Government or the Government of Indonesia.

[2] Shahidur R. Khandker, *Fighting Poverty with Microcredit: Experience in Bangladesh*, Oxford, U.K.: Oxford University Press, 1998.
Mark J. Roberts and James R. Tybout, *What Makes Exports Boom?*, Washington, DC: World Bank, 1997.

The first point is tautological, so that to the extent that industrial promotion for small firms can be demonstrated to produce net benefits measured by increased production over the opportunity value of the costs incurred it should be done. The second two rationales are less clear as generalities, but may be demonstrated in particular cases. In particular, it is alleged that since regulators are not sensitive to SME needs, regulation of the financial sector needs to be done so that SME are not discriminated against. Second, the quality of society and the polity may be promoted by having more SME than the market might dictate. The advocates of the Ekonomi Rakyat, for example, look to a society where a much larger part of economic activity than at present is conducted by SME.

Financial market regulation is justified in the first instance because financial markets are based on promises of future performance, which must ultimately be enforced. To avoid the inconveniences of private enforcement, the state is called in. Thus laws regulating financial instruments and institutions emerge. Second, to the extent that customers are dispersed and there is disparity in the information they and financial institutions have, the government is concerned to protect consumers from fraud. Finally, a failure of a significant number of financial institutions is likely to have strong negative systemic effects on the economy, and the government is inclined to prevent it. All of these result in the provision of prudential supervision to formal sector financial institutions, often in return for various privileges such as the possibility of their paper being accepted by the government in payment for debt.

Historically, the process has been less rationale than the foregoing would indicate. The privileges of formal financial institutions emerged in compensation for financing the government's economic needs. However, like Voltaire's god, good formal sector financial institutions have proved to have other merits in modulating overall economic activity and this has become the major motive for their regulation. Finally, sometimes the promotion of particular instruments and institutions or the provision of public capital is seen as a device to promote production and welfare. In particular, the provision of particular financial services to SME is seen as an effective means to promote them.

Whether this is so is connected with two facts that must be established empirically in each case.

Whether finance is the critical missing factor in SME growth[3]

[3] This refers to the theory developed by Don Mead and others that through analyzing subsectors, as is done in agricultural economics, it should be possible to identify in each case which of the potential constraints to enterprise development is the binding one – whether it is lack of finance, or skills, or of markets. Clearly if the latter two are the binding constraints no provision of finance will assist SME.

The approach represents a departure from the previous "comprehensive" approach when it was assumed that a SME promotion effort should provide all the necessary elements for enterprise development. The cost and frequent ineffectiveness of this approach, led to the more focused – "critical missing factor" -- approach which is now the norm.

See James J. Boomgard, Stephen P. Davies, Steve Haggblade, and Donald Mead, "Subsector Analysis: Its Nature, Conduct and Potential Contribution to Small Enterprise Development," Michigan State University, Department of Agricultural Economics, International Development Papers No. 26, East Lansing, Michigan: 1986.

Whether the finance provided will be used for SME or through fungibility for other activities.

In the case of Indonesia the demand for financial services at market rates by SME and anecdotal evidence of excess demand at those rates suggest that finance is sometimes a critical missing factor. But, as will be shown below, no studies directly establish this fact. On the second question, it is clear that some proportion of small scale finance does support SME that would not exist without it.

The questions then to be addressed in this paper are:

Whether the Monetary Crisis has negatively affected SME through its effect on small scale finance.

Whether steps to reform or assist the regulatory and institutional framework for SME finance would promote small scale finance and thus SME. If this is case, we then consider what steps might be appropriate.

In what follows, we first survey the state of knowledge about various channels for SME finance in Indonesia, and on that basis recommend various potential interventions to increase the positive impact of SME finance.

Summary Statement

Indonesia has a remarkable variety of institutions providing small scale and micro credit – formal, semi-formal, and informal and they handle considerable volumes of credit – both in comparison to the size of the Indonesian banking system as a whole, and in comparative perspective of other Asian countries. [4] Table IA: Small and Microcredit in Indonesia: Some Characteristics gives some basic data about the major categories of institutions involved. The formal institutions, in recent years, have epitomized what might be described as the ruling paradigm in small scale finance and perhaps financial intermediation in general – they are depositor based, self-sustaining, and move considerable volumes of credit. Further, though the institutions and the SME sector itself have not escaped being affected by the Monetary Crisis,

[4] In what follows it appears that there may presently be at least 10-12 Trillion Rps in microfinance (Loans under $1500) through various specialized channels. If we take an exchange rate of 8000 to the dollar this would mean 1.5 Billion dollars. This is about 2% of Commercial Bank credit to the private sector, and will probably rise as a proportion to 3% as Financial Sector Restructuring proceeds. Official figures in the *Bank of Indonesia Report for the Financial Year 1998-1999* would put the figures of the three main microfinance institutions (BRI's Unit Desa, Savings and Loan Coops, and BPR) at 1.2% of all bank assets. 10-12 Trillion Rps are .75% of the country's estimated 1998 GDP. The small scale credit institutions reach 8% of the people as borrowers, 10-15 % if we include the Social Safety Net Programs.

By contrast, in what is admittedly the far poorer country of Bangladesh a little less than 8 million people are served by microfinance institutions of which 5.4 million are borrowers. This is roughly 1 % of the population. For reference, the credit outstanding of all Bangladeshi microfinance institutions is $274 Million, but only 20% of their "Revolving Loan Fund" is composed of member savings. By contrast, 4.89% is their own capital, 11.30% comes from Bangladeshi commercial banks, 21.30% from an apex fund (which also involves donor funds), and 25.57% from foreign donors.

through which Indonesia is passing, the effects seem relatively mild as compared to those on the economy as a whole.

The formal institutions for microcredit in Indonesia include the Unit Desa network of Bank Rakyat Indonesia (BRI), the Banks Perkreditan Rakyat (BPR) of various sorts but especially the so called new, post-1992, private BPR, and various types of Savings and Loans cooperatives as well to a limited extent as commercial banks. Commercial banks have served the upper end of the small and medium business world in the past – but are now generally constrained by their own financial condition from maintaining, let alone expanding, their credit. All of these institutions have Islamic, shariah variants, which have expanded rapidly in recent years, but resemble the mainstream organizations in most respects (except that their terms of transaction often fluctuate more).

The semi-formal institutions are a vast variety of organizations which give loans and sometimes take deposits – typically with government or NGO support. The precise legal status of this financial activity is often in doubt and many of the organizations are linked with formal institutions in some fashion. Among the more prominent of these are various residual LDKP (Lembaga Dana dan Kredit Pedesaan) promoted by the various provincial governments and various programs connected with the Social Safety Net (SSN/JPS) programs of the Government.

Each of these types of institution serves a different market segment as identified by their characteristic loan size in Table 1. Though they have other differentiating characteristics and clearly do compete with one another at the margin, especially for deposits, they are largely complementary. It is also the fact that regulators at the moment are not encouraging vigorous competition among or between them.

Little study of informal financial transactions has occurred – none of which I am aware which would give a quantitative sense of the dimensions involved.[5] There is no doubt that the country is characterized by a welter of rotating credit arrangements (artisan etc.), money lending, and trade credit.

[5] An ADB project is documented in Dibyo Prabowo, G. Suaningrat, Mangkasuwondo, and T. Prasetiantono, "Study in Informal Credit Markets in Indonesia," September 1989. The exception is the data in the Economic Census of 1996 which reports that roughly 10% of "enterprises without legal status" borrow informally.

Table IA. Small and Microcredit in Indonesia, Some Characteristics

Type of Institution	***Number***	***Amount of Loans***	***Number of Borrowers***
Bank Rakyat Indonesia (BRI) Unit Desa	3701	511 B new lending, 32.3 TN Cumulative, Outstanding 4.3 TN	2.5 Million
Bank Perkreditan Rakyat (BPR)	2262 (New 1423, Shariah 78) (Dec. 1998)	2 TN (Dec. 1998) – of which – Shariah 53 B	2.2 M – Dec. 1998
Savings and Loan Coops*	36,315 (March 1999)	4.2 TN (March 1999)	11 M (March 1999)
Commercial Banks	170 (Dec. 1998)	38 TN (Small Loans)(March 1999)	11 million borrowing accounts of all sorts
PDM-DKE	LKMD in each village	850 M (1998)	NA
PLEPMM	1000	60 B (1998)	Minimum 50,000
TAKESRA/KUKESRA	NA	200 M	9.8 M
Non-BPR small credit (LDKP etc.)	7242	1995 – 317 B	1995 - 1.2 M
Average Large Asian Microfinance Institutions	5	597 Million Dollars	1.3 Million
Grameen Bank	1	$276 Million, Dec. 1997	2.4 Million, March 1999

Table IB. Small and Microcredit in Indonesia, Some Characteristics

Type of Institution	**Average Size of Loans**	**Savings Amount**	**NON PERFORMING LOANS**
BRI Unit Desa	14.6% to 500,000 30.3% 500-1,000-000 31.8% 1-2,000,000	16 TN Rps	Collected 98.3% of principal due in year, 4.5% Portfolio at Risk
BPR	1,000,000 Rps Approx.	1.5 TN (Dec. 1998) – of which Shariah 35 M	45% of banks were reported to be somewhat impaired, but the percentage of NPL is much lower.
Savings and Loan Coops	385,000 Rps (March 1999)	1.3 TN Rps (March 1999)	1.4%
Commercial Banks	Max 350 Million for KUK lending, 98% of borrowers under 50 M.	368 TN Rps (March 1999)	58.7 overall, 23% on KUK lending, 9.4% lost. (Dec. 1998)
PDM-DKE	NA	NA	NA
PLEPMM	NA	NA	NA
TAKESRA/KUKESRA	20,000		
Non-BPR Rural Credit Institutions (Paddy and Petty Traders Banks, BKPD, LDKP)	Much smaller than BPR	1995 – 181 B Rps	Rawicz, 6-20%. Seibel, 2-6%
Large Asian Micro Financial Institutions (MFI)	$290	NA	NA
Grameen Bank	$31, March 1999	$127 M	NA

Source: ed. Bishnu P. Shreshta, *Rural and Micro Finance in Indonesia*, Jakarta: APRACA Consulting Services, April 1999, pp. 73, 75. "Kebijaksanaan Pemerintah Dalam Mengembangkan Usaha Simpan Pinjam," Ir. Deswandhy Agusman, Seminar, Jakarta, Mary 5, 1999. Phone Communications. Dates range between December 1998 and April 1999. Data from Bank Indonesia and Grameen Bank Web Pages May 1999. **Indonesian Observer**, Mary 11, 1999, p. 7. R. Marisol Rawicz, "Search for Sustainable Microfinance: A Review of Five Indonesian Institutions," World Bank Policy Review Working Paper 1878, World Bank, Washington, D.C., Feb. 1998. Hans Dieter Seibel and Uben Parhusip, "Microfinance in Indonesia: An Assessment of Microfinance Institutions: Banking with the Poor," Working Paper 7, University of Cologne Development Research Center, 1997, I think this has since been published as an article somewhere. *Microbanking Bulletin* op. cit.; *Bank of Indonesia Report for the Financial Year 1998-1999***.**

*The figures for Savings and Loans Cooperatives and some other categories differ from those given in a BI source, see Imam Sukarno, "Bank Perkreditan Rakyat (BPR) – Competition vs. Regulation," given at third Annual Seminar on New Development Finance, Frankfurt, September 25, 1999.

Despite the volume of lending and variety of institutions, many Indonesian SME do not have access to financial services for which they would be willing to pay, to say nothing of those which might be provided on a subsidized basis.[6]

Data collected as part of the *1996 Economic Census* shows over 16 Million non-agricultural enterprises "without legal status" (with 29 Million employees total) most of which were quite small.[7] Seven percent of these enterprises did have an activity license. Ninety seven percent had less than 5 employees, 60% less than 500,000 Rps of fixed capital (93% were under 10 Million Rps), and 87% had under 25 Million Rps in revenues. Of these enterprises, 85% had "no loan facility." Of those that did roughly 20% received their loan from a commercial bank or similar institution. Of these bank borrowers one third had KUPEDES loans (from BRI). See Table II.

Table IIA : Enterprises Without Legal Status in Receipt of Loan

Region	**Number**	**Loan Amount**	**Non-Institutional**	**Bank**	**Coop**	**NBFI**
	Thousands	In B Rps	In B Rps	In B Rps	In B Rps	In B Rps
Sumatra	2744	381	288	60	28	5
Java/Bali	11367	1810	1373	325	64	49
NT	550	90	57	19	11	3
Kalimantan	838	116	95	17	3	1
Sulawesi	1129	176	131	35	8	2
Maluku and Irian Jaya	183	23	18	4	1	-
TOTAL		2596	1962	460	112	62

Source: *1996 Economic Census*, op. cit., Table 18, pp. 29-30.

[6] Peter van Diermen, *Small Business in Indonesia*, Aldershoot: Ashgate, 1997, pp. 138-141.

[7] *1996 Economic Census: A Profile of Establishments Without Legal Identity: Indonesia 1996***.** Jakarta:Buro Pusat Statistik, 1998., pp. xiii-xv.

Table IIB : Enterprises Without Legal Status in Receipt of Loan

Region	**Total Bank**	**KUPADES**
	In Million Rps	In Million Rps
Sumatra	60	17
Java/Bali	325	114
NT	19	7
Kalimantan	17	4
Sulawesi	35	9
Maluku and Irian Jaya	4	-
TOTAL	460	151

Source: *1996 Economic Census*, op. cit., Table 20, pp. 31-32.

In fact, much of the small credit now provided is not even enterprise credit, but enables seasonal or temporary smoothing of consumption patterns. Of the commercial bank lending to the small scale sector of 38 Trillion, roughly 16 Trillion was for consumer/housing loans. For reference of the remainder 1.5 Trillion was routed through the Coops. All bank lending statistics, when many loans are non-performing are questionable. But SME lending is proportionally less impaired than large scale lending.

How all of this is affected by the present Monetary Crisis is still an open question. Two World Bank staff members raise the question of whether there is in fact any shortage of bank credit.[8] My interviews with commercial banks indicate that many of the bigger ones have freezes on new lending. Others are looking for new loans to remedy their negative spread but say they do not have demand for small enterprise credit. The only lending many banks were doing was under directed, special refinance lines of the Bank of Indonesia. As soon as the banks are recapitalized this freeze on lending will end. Lending to SME has fallen more rapidly than lending as a whole. In early 1999, the three specialized microcredit networks reported outstandings of roughly 11 Trillion Rs. ($1.4 Billion), down a bit from the previous year even in nominal terms. BRI had experienced a considerable increase in deposits. From June 1997 to June 1998, BRI Unit Desa loans increased 6.8% in current prices and decreased 33% in constant prices. Savings increased 75.4% in current and 10% in constant prices, reflecting partially a flight from BPR deposits.[9]

BPR loans declined from March 1997 to March 1998 by .8% in current prices and 28.7% in constant prices. Savings declined by 3.3% in current and 30.5% in constant prices. Total BPR

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[8] Wei Ding, Ilker Domac, and Giovanni Ferri, "Is There a Credit Crunch in East Asia," unpublished paper, World Bank say: "The situation in Indonesia is controversial. On the one hand, there is no striking indication of a country-wide credit crunch on the basis of movements in monetary and credit aggregates; on the other, strong sectoral shifts in the flows of funds occurred, likely leading to bottlenecks in the availability of financial resources and to localized credit crunch."

[9] Paul MacGuire and John D. Conroy, "Effects on Microfinance of the 1997-1998 Asian Financial Crisis," Paper at the "Second Annual Seminar on New Development Finance," Frankfurt, Sept. 21-25, 1998, p. 5.

assets did not decline with savings because of new credit from BI covered elsewhere in this paper.[10] Outstanding commercial bank credit in small loans was 38 Trillion Rps in March 99 down from 66 Trillion in April 1998, and more than back to the 50 Trillion of March 1997.[11]

Whether using current urban prices to get constant prices is analytically correct is a question but no rural based deflator exists. If such a deflator had existed it might deflate less and the constant price data might be closer to the current price data. In both the cases of the BRI and BPR arrearages have increased, but not dramatically. For BRI the increase has been less than 1% of outstandings. BPR figures have risen somewhat more, for the year to March 1998, three surveyed BPR report they have risen from 9-12%, 15-32% and 23-32%.[12] Official figures show a rise on average from 18.7% of portfolio to 21% from December 1997 to December 1998.

Commercial bank Non Performing Loan by small enterprises has risen since the crisis, but nowhere near to the levels reported for most commercial bank lending, and it is likely that much of this is a contagion effect from others not paying, rather than real difficulties.
On the borrowers' side, one study of SME shows a slight shift away since the crisis from dependence on external finance, probably also reflecting a decline in the use of external finance. Whether this is motivated by declining need for working capital or lender attitudes is not made clear.[13]

A more recent study, concludes that the impact of the Monetary Crisis differs between sectors and regions, and that the impact of the Monetary Crisis is probably low on the small scale sector considered as a whole. Export industries did well; those supplying domestic markets with

[10] MacGuire, op. cit., pp. 6-7.

[11] Table 1.24 and 1.26, Statistics on the Bank Indonesia's Web Page, Jakarta: Bank Indonesia, n.d. Total Commercial Bank Lending was 366 Trillion Table1.14 ; MacGuire, op. cit., comes to a conclusion that microcredit institutions in Indonesia are affected.

[12] MacGuire, op. cit., p. 9 citing Xavier Reille and Dominique Gallman, "The Indonesian People's Credit Banks (BPR) and the Financial Crisis," Paper from "Second Annual Seminar on New Development Finance, Frankfurt, Sept. 21-25, 1998.

[13] Agustina Musa, "A Study on Access to Credit for Small and Medium Enterprises (SMEs) in Indonesia: Before and After the Economic Crisis (1997-1998)," Jakarta: Asia Foundation, 1998 reports the following patterns for entrepreneurial finance:

Source of Funds for Small Business

Period	**October 1996-September 1997**	**October 1997-March 1998**
Source of Finance	Percent	Percent
Self	72.7	75
Private Bank	4.2	3.5
State Bank	11	9.2
Supplier	3.1	1.5

imported raw materials, poorly.[14] These differentiations are independent of those of the relative impact on the poor which may be severe even in booming areas because of rising food prices and lagging wage adjustment.

More data on the state and credit problems of SME in the post-Monetary Crisis period will soon be released by the Central Statistical Bureau. Some of the Central Statistical Bureau data are being discussed at this Seminar. Other data will be available from the survey commissioned by Bank Indonesia on Small Enterprise from *ECONIT,* which is now in process.

My own conclusion is that though the overall immediate effect of the Monetary Crisis on SME and the financial institutions that serve of them has been relatively mild – some of the ensuing changes in financial institutions might have stronger negative effects: particularly, the increased conservatism of lenders and the enhanced role of foreign bank owners who have less of a feel for Indonesian SME. Some measures might be desirable to counter these changes and are presented later.

As a generalization, Indonesia is marked by an absence of empirical study of the finances of SME on an enterprise level. This is complimented by an extensive body of study of small scale credit programs and institutions.[15] The lack may well reflect a skepticism about SME furnished financial data, accompanied by a confidence that the flourishing state of the financial institutions that serve SMEs reflect the fact that enterprises are being well served. It may be that Indonesia has reached a cross-roads where some data about enterprise finance would be valuable, particularly in pinpointing whether finance rather than demand or raw material constraints is the "critical constraining factor" in SME growth. Other Asian countries have an extensive body of

[14] Tim Usaha Kecil, "Studiee Monitoring Dampak Krisis Terhadap Usaha Kecil," Bandung: AKATIGA, 1999

[15] Three recent assessments of the significance and merits of various microcredit agencies are those of Rawicz op. cit.; Richard Meyer, chapter in Indonesia in forthcoming volume; Seibel op. cit. Seibel's study surveyed MKEJ (Mitra Karya of East Java, a Grameen Bank Replicator, P4K (Pembinaan Peningkatan Pendapatan Petani-Nelayan Kecil), Bank Shinta Daya (a BPR owned by a social organization), and Bank Purba Danarta (A small commercial bank also owned by an NGO). Rawicz compares five microcredit schemes – The South Kalimantan Badan Kredit Kecamatan (BKK), the Lembaga Kredit Pedesaan (LKP), the PHBK (Program Hubungan Bank dan Kelompok Swadaya Masyarakat), P4K, and BKD (Badan Kredit Desa). These are all small end institutions of the LDKP and Social Safety Network sort. Actually, in a technical sense the PHBK does not involve a separate institution but social organizing to link self help groups with banks, BPR etc. The roughly 5700 BKDs in Java and Bali and similar TPSPs elsewhere (about 1000 of them in the cooperative category at the time of study now perhaps 140) are staffed and supervised by BRI. The P4K was a BRI program, though not of the Unit Desas.

Rawicz's group range in size from the LKP with an annual loan volume of $313,000 to the BKD network with a loan volume of $113 Million in 1995. The average size of loan varies from $67-99, and because of currency devaluation might now be half of that. Of Seibel's groups, MKEJ had over 1000 members in 1995. Bank Shinta Daya had 13,000 borrowers and Bank Purba Danarta had a couple of 1000. The precise findings of these studies are not so much important but they again underline the success of a variety of different – deposit based, largely commercial approaches to small scale and especially microfinance in Indonesia. We should also note Stephanie Charitonenko, Richard H. Patten, and Jacob Yaron, "Case Studies in Microfinance: Indonesia: Bank Rakyat Unit Desa, 1970-1996," http://www-esd.worldbank.org/htm/esd/agr/sbp/98abst/brifin.htm.

small enterprise finance data, much of it developed, using models already applied to agricultural economic questions.

In addition to questions about its penetration and the effect of the Monetary Crisis, the small scale finance is also not equally distributed over the country though the lack of balance is not so marked in comparative terms with that of other countries. Nonetheless, as in all large nations questions of political equity in distribution are always important. Whereas the BRI has a nationwide network as do the cooperatives – commercial banks and BPR are concentrated in some regions, especially in Java and Bali. Sixty nine percent of bank offices, 73% of all BPR, 88% of commercial bank credit and 86% of commercial bank deposits are in Java and Bali – which account for roughly 65% of the country's population. Seventy percent of that bank credit is booked in Jakarta alone, presumably often supporting activity throughout the archipelago.[16] On the other hand, only 65% of cooperative credit is reported in Java, Bali, and South Sumatra.

To increase the amount of small scale finance particularly outside of Java, the provincial governments created various sorts of LDKP some of whom have been transformed – as is intended for all – into BPR. There has been a pause in the formation of new BPR by the private sector, both because of policy changes in process and the Monetary Crisis. Several plans, however, exist to resume the rapid growth of BPR that had been going on since 1992, particularly in underserved areas – though changes in regulations and new prudential rules mean that the pace may be somewhat slower than before.

But even when the financial services reach the small scale entrepreneur in Indonesia their costs may be high. In crossnational comparative terms, many of the institutions enjoy quite high intermediation margins – partially accounted for by high administrative costs and in some cases by the cross subsidization of other larger scale economic activity.

Table III, Margins in Small Finance Intermediation in Indonesia, gives some of the data to assess the efficiency of the organizations concerned. Of course, each country is unique and there is no reason to assume that intermediation costs should be the same in Indonesia as elsewhere. Margins may be lower in South Asia, for example, because of relatively low professional wage rates. But the gaps indicated show that there should be room for improvement.

[16] **Economic Statistics**, Oct. 1998.

Table III – Margins in Small Finance Intermediation in Indonesia

Type of Institution	**Average Return on Portfolio of Loans to Private Parties**	**Average Cost of Funds in the Form of Deposits from Private Parties**	**Average Margin for Private Sector Intermediation**
BRI Unit Desa	20.2% (1995)	.3% (1995)	
BPR	44% (1999)	17% (1999)	27% (1999)
Savings and Loan Coops	3.5% a month (March 1999)	2.5% a month (March 1999)	1% a month
Commercial Banks	Negative	High	Negative
Non-BPR Rural Credit Institutions(Paddy and Petty Traders Banks, BKPD, LDKP)	Seibel 24-30 Rawicz,	Seibel 10-14	Seibel 10%
Large Asian MFI	28.1	13.1	18
Grameen Bank	8.5	11% ?	2.5

Source:.Charitonenko op. cit.: Rawicz, op. cit.; Richard Meyer, chapter in Indonesia in forthcoming volume; Seibel, op. cit.; **Microbanking Bulletin**, op. Cit., and Grameen Bank Website. Calculation of spread for 7 BPR visited by author. These were among best rather than representative.

NOTE: there is an issue here with the concept of the cost of funds and return on portfolio. Banks, quite naturally, focus on their marginal costs of funds in determining their lending rates, but from a systemic point of view – comparing overall social costs of intermediation, it seems more appropriate to look for the average cost of funds, which is what is given in the above table.

Most of the SSN programs involve simply "channeling" government funds to beneficiaries and do not concern themselves with establishing sustainable intermediaries.

Differentia: The Role of Government

Another distinguishing feature of all institutional finance for the small sector in Indonesia is the dominant role of the government (though this is less unusual in Asia than Latin America or Africa). Though all small credit institutions by definition must have a "decentralized" credit culture, the strategic decisions are typically made by government controlled organizations in

Indonesia.[17] In fact, since the Monetary and attached Banking Crisis – there has been a minuscule privately owned banking sector in Indonesia, even if NGO sponsored institutions are included. Presently, 15% of all bank assets are in privately owned banks. If local government owned banks are counted as private banks, as they are frequently in China, the role of non-government finance would be higher.

Caveat Statistica

Before we go further with data about finance in Indonesia two items should be noted. Financial statistics are reported in nominal terms. With a doubling of the exchange rate of the rupiah versus the dollar, and accompanying inflation a rupiah is worth a lot less than it was in 1996 or even 1997. Consequently, even moderate increases in financial volume imply a real decline. Second, financial institutions all over the world report figures including non-performing loans and then provision for them. Even in cases where we can assume that adequate provisions are being made – the provisions will not be reflected in the raw lendings which include bad loan figures. Eventually, the bad loans should be provisioned against and the provisions should reduce the capital and retained earnings figures (in Indonesia's case frequently to negative levels) and thus be reflected in lower total assets.

Credit repaid should lead to increasing wealth both for the borrower in terms of the excess of accumulated earnings over repayments and for the financial institution in terms of their net earnings. Credit non-repaid obviously diminishes the wealth of the financial institution and its ability to loan to others – but typically it also reflects credit misused which does not result in increased wealth for the borrower either. It is in this sense which people characterize bad debt as changing gold to dross.

History and Political Economy

The Indonesian banking system has gone through several cycles of expansion and contraction since independence.[18] The present structure is the dialectical result of a liberalization in the detailed regulation of financial intermediaries and of prudential consolidation starting with the PAKTO reforms in the early l980s and culminating in the new Banking Law of 1992. This process, at least in theory, opened the system to private entrepreneurs at the same time imposing

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[17] People with experience of large scale banks who enter the small scale lending field in developing countries often resist the necessity of a decentralized credit culture. They try to impose credit scoring systems and other assembly line credit assessment technologies that are used in the United States and Europe. In the absence of the reliable data bases these imported techniques generally require, their applicability is questionable. An active debate on the usefulness of credit scoring for microcredit institutions in development countries recently took place on the Development Finance Mailing List based at Ohio State University.

[18] David C. Cole and Betty F. Slade, *Building a Modern Financial System: The Indonesian Experience,* Cambridge, UK: Cambridge UP, 1996. Cole and Slade see these cycles as based on competition between ideologically defined groups for control over the banking system and its resources, pp. 328-333, particularly what he calls the technocrats and the interventionists. The former committed to a more market, the latter a more dirigiste approach. Another more recent view is contained in Ross H. McLeod, "Banking Deregulation and Re-Regulation in Indonesia," *Journal of Asian Pacific Studies* 1999.

prudential standards. Quite obviously, some private entrepreneurs took excessive advantage of their opportunities as others milked the government banks, and prudential standards were not adequately enforced. We are now, necessarily, in a period where enhanced prudential standards can be expected, though their form is not yet entirely clear. For the first time since the 1950s, foreign controlled institutions may play an large role in the system, but the system is likely to be more conservative in permitting new private financial intermediaries of any sort to develop.

The 1992 Law envisaged a pattern in which BPR, as regulated intermediaries, displaced the welter of pre-existing small financial institutions, or in which these small institutions became savings and loan cooperative units of one sort or another – but the sponsors of many of these small institutions were not willing for either of these to happen.

At the moment, prudential rules for all financial institutions are being revised. A modified CAMEL has been applied to BPR and one was introduced for credit cooperatives in March 1999. The majority of BPR and reportedly savings and loan cooperatives have already been inspected in according with its terms. A similar scheme for commercial banks, including BRI with its Unit Desas, is already in existence. Whether a scheme of the breadth of CAMEL is appropriate for relatively simple intermediaries for whom the critical problem is impaired assets – and when capital is not adjusted for provisioning (as in BPR) is open to question. It might be better to rely simply on a measure of asset quality.

At the same time, in accordance with the new statute of the Bank Indonesia it is getting out of the business of bank supervision and "development" functions in the form of administering targeted and subsidized credit lines for small industry, agriculture, cooperatives, and exporters. Agricultural credit is to be transferred to BRI, housing finance to BTN, small scale credit has been designated for transfer to PT Madani by the end of October 1999, export finance to Bank Ekspor Indonesia and bank supervision to a new agency by 2002. The Bank Indonesia will retain overall policy responsibility for the soundness and regulation of the banking system including the BPR and for the payments system. Presumably it will thus also concern itself with how adequately bank regulation serves the interest of trade, agriculture, and industry. What sort of residual capacity it will have to deal with these matters, and what capacities will be created in PT Madani and the new Bank Ekspor Indonesia is still being worked out.

The Institutions

The Bank Rakyat Indonesia and the Unit Desa

The Bank Rakyat, a large government owned bank with an old and extensive countrywide network has a network of 3701 Unit Desa's which handle small loans and savings through its Simpades and Kupades products.[19] These are Unit Desas not to be confused with the 5700 or so "BKD's" (small credit institutions spread over Java and Bali – which are legally BPR) and TPSP's (similar savings and loans cooperative units elsewhere) over which BRI has supervisory

[19] There are a considerable number of published studies on the BRI Units. Two of the more recent are contained in the Charitonenko and Shreshta pieces cited elsewhere in this piece.

responsibility, provides some staff to, but which are owned by local governments in the BKD's case and staffed partially by unpaid local residents.

The Bank Perkreditan Rakyat (BPR)

The BPR were created as a legal category under the 1988 Banking reforms. They are permitted to borrow and lend money but do not have access to the payments system, have lower capital requirements than for commercial banks and are subject to inspection by a special department of the Bank Indonesia, the Urusan BPR. Under the newest rules they must have 500 Million Rps capitalization in smaller centers, one Billion in district towns, and 2 Billion in the JABOTEK area around Jakarta. Some of these BPR are newly formed and privately owned, sometimes by non-governmental organizations, but also by private parties, and even commercial banks. See Table IV attached. Other BPR were formed out of pre-existing LDKP, small savings and credit units promoted by the various provincial governments.

Savings and Loan Cooperatives

The savings and loan cooperatives many of them registered with the Ministry of Cooperation and Small Scale Enterprise (Depkop) include roughly 1000 pure credit coops (including credit unions) (KSP), but are primarily credit units (USP) within larger urban and rural cooperatives (KUD). They number roughly 38,000 in total. There are also numerous unregistered savings and loan coops. They have 12 Million members with assets of 5 Trillion Rps, loans of 4 Trillion, and savings of 1.3 Trillion as of Dec. 1998. The lack of registration and the limitations on the Ministry's ability to check these figures mean that they may be inaccurate. See the asterisked note to Table I attached, this source also has global figures on the social safety net programs below.

The Social Safety Net (SSN/JPS)

A variety of loan programs are included under the SSN. Under the PDM-DKE (Regional Self-help to Alleviate the Impact of the Economic Crisis) program which is part of the Social Safety Network Program (JPS), informal popular organizations called LKMD in each village of the covered areas were given 60 Million Rps which they could either use for public works or as a loan fund. Though the exact figures is not clear and varies from village to village and time to time, it appears that about half of these funds went into loan funds. There are no central figures on the further disposition of these loan funds.

In a similar program sponsored by the Depkop, 1000 LEPMM (cooperatives with a minimum membership of 50 each) were given 59 Million Rps in funds, 70% of which was to be used as interest free loans to their members.

Under the TAKESRA/KUKESRA Program (Tabungan Kesejahtera/Kredit Usaha untuk Kesejahteran Rakyat), run by the BKKBN, the family planning agency, women received a combination of grants and loans. They received four thousand Rps if matched by 23,000 of their own savings, and a 20,000 Rps loan at 6%. As many as 9.8 Million women qualified for this combination.

Shariah Intermediation[20]

Most of the financial institutions treated above have a shariah variant. These shariah institutions modify the operations of the institutions and their instruments to conform with the strictures of Islamic law, shariah. Some tendencies within Indonesian Islam do not feel that these adjustments are necessary, but many people especially those connected with the Mohammadiyah movement have felt the need for shariah institutions. By comparative standards, the Indonesian institutions are relatively new and just finding their way, as compared to the broader and older Iranian, Pakistani, Sudanese and Saudi national systems, and individual Islamic banks in non-Islamic systems especially in Egypt, the Gulf States and the West. The shariah Bank Muamalat had 447 Billion Rps in assets in December 1998, and 78 shariah BPR, 80.5 Billion Rps The 2470 shariah BMT cooperatives as of June 1998 of which roughly 200 are estimated to be registered with the Depkop have 187 Billion Rps in outstanding loans, mostly to microenterprises as of June 1998.[21] The 1500 Kopontren Cooperatives connected with Islamic hostels are registered with DepKoop, but most of their savings units do not follow the shariah system, though they are beginning to do so. In addition, there are the nascent shariah branches of the regular commercial banks. The shariah BPR and cooperatives have been growing in number and size despite the Monetary Crisis.[22] Though they offer the full range of shariah deposit and credit products, most of their credit has been in the form of trade finance (Bai al Salaam, Bai Bitsama Ajil, Istishna, or Murabaha), though the proportion is generally declining as the partnership or trust provision of working capital (Musyarakat and Mudharabah) increases.[23] Appendix A to this paper, Islamic Financial Instruments, contains an excerpt from the annual report of Bank Muamalat describing these instruments. The actual rates charged and paid differ considerably between institutions and from time to time – as they should in order to share risk with their clients, but the average rates on shariah credit often seem to approximate those of other institutions. In recent periods the payments to depositors by Bank Muamalat and the shariah BPR have often been somewhat lower, but they report that they have lost relatively little in the way of deposits because of depositor commitment to shariah banking. Of course, this has enabled them to escape the negative spread problem of commercial banks.

[20] Thomas A. Timberg, "Islamic Banking in Indonesia," manuscript, August 1999.

[21] Interview with Dr. Amin Aziz, PINBUK, July 2, 1999 and Dr. Amin Azis, "The Development of Micro Enterprise Institutions in Indonesia: The Case of National Board of Revenue Sharing Micro Enterprise Cooperatives (INDUK KOPERASI SYARIAH BMT, BAITUL MAAL WAT TAMWIL), Presented at the Symposium of the APEC Center for Entrepreneurship, Jakarta, August 10, 1999.

[22] Bank Muamalat, *Annual Report 1998*, Jakarta: Bank Muamalat, 1999.

[23] For Bank Muamalat the allocations for 1998 and 1997 were as follows in Billions of Rps:

Type of Loan	**1998**	**1997**
Bai Bitsaman Ajil	219	266
Murabaha	154	151
Mudharabah	75	30
Musyarakat	13	

Other Non-Bank Financial Institutions (NBFI)

Indonesia has the full range of non-bank financial institutions many of them operating at a significant level. The figures in Table IV – Non Bank Financial Institutions in Indonesia cover only the legally recognized ones.

Table IV – Non Bank Financial Institutions in Indonesia

Type	**Volume of Activity**	**Number of Companies**
Finance	39 TN Credit Outstanding	245
Leasing	16 TN	
Factoring	8 TN	
Consumer Finance	5 TN	
Credit Card	--	
Venture Capital	124 B	61
Insurance and Reinsurance	32 TN (Total Assets)	178
Pension Fund	16 TN (Total Assets)	306
Pawnshops	800 B	633 Offices
TOTAL	88 TN	1523

Source: *Bank Indonesia, Report for the Financial Year 1998/99.*

NBFI have declined somewhat because of the crisis, with the exception of the Pawnshops and Pension Funds, which have grown. They clearly represent important funding sources for SME, but I have not yet had time to study them in detail.

Characteristics of Microcredit Institutions

Overall commercial bank lending and small enterprise lending with it should decline as bad loans are transferred to IBRA. Mel Brown of IBRA estimates that overall bank lending will eventually fall to roughly 300 Trillion Rps.

Commercial bank Non Performing Loan figures, were reported by Bank Indonesia as 58.7% in December 1998. One public statement estimated them at 75% and rising, and that seems consistent with the provisioning levels recorded. The figures on the smaller KUK loans are much lower as shown in Table IIB, 23%. Nonetheless the press contains considerable discussion of the needs to provide relief for KUK borrowers who are in arrears and several efforts to do so are underway. It is reported that 45% of BPR are not healthy or almost healthy, though since the banks involved are often smaller one the proportion of Non Performing Loans should be much lower. Their reported NPL rate as reported earlier rose from 18.7% to 21% of their portfolio between December 1997 and December 1998.

All of the specialized microcredit institutions lend primarily to traders for working capital and for consumption purposes, at rates which were somewhat higher than the market norm for larger loans and paid amounts for deposits which were generally considerably lower. See Table II. Many of their loans are for consumption purposes. It is estimated that roughly 10% of BPR credit and probably of other small credit providers as well goes directly to manufacturers. It is not clear that this fact is of significance per se, since traders finance goods during the bulk of their time passing through subsectoral channels. Non-working capital financing is not the normal task of commercial banks, and is harder for them to manage. For the smallest enterprises, almost everywhere in the world, fixed capital comes from equity.

Second Tier and Two Step Credit for SME – Program Loans and Liquidity Credits

Concessional credit lines, "program loans," have a long history in Indonesia – but since the financial reforms of the early 1980s they had fallen into disfavor and have been systemically reduced. To the extent they were continued the concessional element was supported from the government budget. Even those who advocate them at present do so only as a temporary emergency measure. It was generally felt that the concessional programs, particularly because of the grant element they involved attracted politically powerful claimants and were poorly managed. The result is that their targeting did not work, and their impact was limited.

At the same time, in the early 1980s subsidized credit lost favor internationally on precisely the same empirical grounds as in Indonesia, as well as the fact that subsidized credit was inherently limited because of the high budgetary costs of sustaining it. Subsidized turned out usually to mean less credit.

The concessional lines were revived to a limited, budget constrained extent to assist sufferers from the Monetary Crisis. The new program loans were primarily funded out of the liquidity funds provided the commercial banks by BI, the terms for which were liberalized. Commercial banks became channeling agents for some of the program loans, which meant that they took no credit risk in handling them. However, the actual increase in funds was relatively small and mostly concentrated in agricultural credit.

After the Monetary Crisis, for the first time, concessional second tier or two step lines of credit were allocated to the BPR from the Bank Indonesia of about 150 Billion rps in January 1999, of which it was reported 106 Billion were used.[24] For the commercial banks, twenty seven Trillion Rps of liquidity credits were outstanding in March 1999 – 2.4 to cooperatives, 4.1 to agriculturists, and 12.5 in the miscellaneous category into which small industry falls, though they must account for a small proportion of the total.[25] (It should be made clear that these loans to cooperatives were to cooperatives of all sorts, not particularly savings and loan cooperatives which normally do not receive bank funding).

A more powerful influence on small scale enterprise lending has been the requirement that commercial banks lend a certain proportion of their funds to small enterprises, "so-called" KUK funds. The program loans (directed finance lines) are partially counted in the KUK figures, especially the agricultural and cooperative portions. The obligation to make these loans has

[24] *Bisnis Indonesia*, July 8, 1999.

[25] Table 1.13, Bank Indonesia Liquidity Credits and Direct Credits from Bank Indonesia Web Page.

been suspended for 1998-99 and the level of such loans has declined dramatically as indicated elsewhere.

Since the targeted and concessional programs are scheduled for transfer to PT Madani within six months (by the end of October 1999), there is considerable uncertainty about their future. There are no indications that further funds will be provided for these loans, and since a considerable part of them are in arrears they may slowly evaporate.

In addition, various international trade credit was provided in different forms by the BI. Some increase in these programs was also authorized after the Monetary Crisis. The trade credit lines were designed to compensate for the rapid fall in the availability of such credit – the volume of international Letters of Credit (LCs) fell to a third of its former level over the period 1997-1998. Some of the slack may have been made up through offshore financing, but this is difficult to determine. The decline in trade credit is blamed for the inability of exports to rise dramatically despite the devaluation of the rupiah.

The BI trade credit goes to both small and large units. There have been complaints that the bulk of the special credit has gone to two large state trading enterprises. In addition, many of these lines, such as the one Billion dollar JEXIM loan, have hardly been used – whether because of a lack of demand or because the commercial banks were unable to handle them. In any case, as with small scale credit these are to be transferred to a new Export Bank, the details of which are still being worked out.

Conclusion

Build on Strengths

SME finance in Indonesia had some institutional development successes in the years up until the Monetary Crisis. These successes included the development of a comprehensive set of institutions serving all levels of the market. The financial institutions concerned were less efficient and comprehensive than we would wish and faced certain difficulties even before the Monetary Crisis. In some cases, these have been exacerbated or changed in form by that Crisis. In general, what needs to be done has changed little.

Many of the financial institutions are financially and structurally weak – this is now manifested, in some cases, in their financial difficulties – but even before those difficulties it was manifest in high transactions costs and limits on their penetration of the market. The overwhelming number of SMEs was not served. In these circumstances, the focus should be on the volume and penetration of small scale lending, rather than its rates. Usually cheaper credit means less credit. Availability is generally much more important than price as far as credit for SME is concerned – though the detailed studies of enterprise finance suggested later in this paper may help verify this in the Indonesian case. With this in mind, those who wish to assist SME might move their focus from allocating a small and hard to target sum from special programs to the more difficult task of helping SME access credit from the market. This task may interact with promoting new institutions and instruments that facilitate SME finance.

Commercial Banks

Especially without the prod of the mandatory KUK lending, the relation of SME lending with new commercial bank lending will depend on several factors. Some banks will seek out and develop SME clientele as an element of their competition for a broader retail banking segment. Banks with a wholesale orientation, lacking retail branch networks, may place extra funds with retail oriented banks and BPR.

To facilitate this SME lending external bank supervision needs to be conducted so that it does not penalize commercial banks for SME lending – either at the wholesale or retail level. Then internal bank systems must be developed which enable banks to lend to SME efficiently and prudently.

If the supervision and systems preconditions are not met and if SME lending does not revive it is likely that legislation or regulations will be demanded to compel some level of SME lending. However, there is no reason to think that SME lending will not recover on its own, and that such government action will be required or demanded.

Many private banks (Bank Bali, BCA, NISP, Bank Danamon, Bank Niaga, and Bank Buana among others) formerly had SME lending as part of their basic strategy. There is no reason to think, even with new foreign owners, that several banks will not do so again.

Properly managed small and medium scale working capital and trade credit based on security and careful cash flow analysis would be a better strategic focus for many banks than fancier larger scale credit. If the banks concerned could increase their role in the payments system this would facilitate managing such credits. Credit cards have spread rapidly, but bank drafts and transfers are still slow and costly. The model to be followed is one in which a commercial bank handles an enterprise's cash flow and is thus able to assess its debt carrying capacity and probably to collect its dues automatically. This model is obviously easier to achieve with smaller companies.

For wholesale commercial banks without local networks means are required to connect them with smaller financial institutions like the BPR and cooperatives. These connections need to be addressed in the regulatory and supervisory frameworks for commercial banks and smaller financial institutions and be assisted by the creation of market infrastructure for lending by commercial banks to smaller financial institutions and vice versa. The forms of this infrastructure can be quite varied depending the on the demands of the participants. They may emerge spontaneously, but especially because of the chastened nature of markets in Indonesia, they might benefit from official sponsorship and even assistance as a token of such sponsorship. They could include electronic markets, brokers, new financial instruments, or full fledged intermediaries.

Unfortunately, many commercial bankers feel that larger scale lending is safer than small scale lending. In the conservative banking days which are likely to be with us for some time in Indonesia, bankers will be reluctant to lend to small units. At this moment, the commercial banks are debating their strategic plans – and it will be important to see how many opt for retail banking as their prime activity. For those that do, technical assistance and regulation should encourage them to lend to SME borrowers.

The matter is complicated by the fact that the overwhelming bulk of the banking sector is likely to be government owned for some time – so that the assumption that bankers are interested in maximizing their return on equity may be more questionable than usual. The use of incentives such as credit guarantees and insurance and higher yields to SME lending may also be inhibited. For government banks, it is important that government controllers be favorably oriented to SME lending, not only in their statements to the press, or in supporting occasional giveaway programs, but in integrating SME lending in their profit making strategy. The success of BRI with the Unit Desa and the plans of Bukopin with respect to Swamitra indicate that small scale lending can be profitable. Needless to say, BRI's plans for its retail operations would seem to bode well that BRI will "mainstream" SME lending in the future.

I understand that there is some desire to institutionalize private sector like systems in the government banks. Though not impossible, this tends to be a difficult task. Allan Shick in a recent article points out that private sector systems for public institutions work in New Zealand because it has a broad tradition of such private sector systems in the private corporate sector. He argues that developing countries which lack such functioning private sector systems often have problems implementing them.[26] To the extent that government banks are governmental, they may need policy direction on how to relate to SME.

Other banks will be acquired by foreign owners lacking experience of Indonesian SME. Special encouragement may be required to assist them in SME lending. In particular, a true intermediary, which assumes credit risk, may be required between them and BPR and other small financial institutions.

Microfinance Institutions

The future of BRI's Units is intimately tied in with the reorganization of that bank itself as a whole, and the proposal that the bank may also contain a parallel system of retail branches dealing with somewhat larger scale customers. If that is the case, we need to consider even further what use will be made of the Unit Desas large profits. There is also a concern about how the sturdy Unit Desas will fare if they become major conduits for subsidized government credit lines.

The BPR, though generally in better shape than the commercial banks, need to go through a parallel process of closing some BPR and restructuring others. Whether a formal program of recapitalization will be required is unclear. Further, there is a need for a tightening of procedures and lessening of costs and a more aggressive marketing orientation. Upgrading management is already occurring as networks of BPR put out standard management packages – just like a franchiser. I visited one bank, taken over by a private chain which had moved from 95% NPL to under 5% in one year.

[26] Allan Shick, "Why Most Developing Countries Should Not Try New Zealand's Reforms," *The World Bank Research Observer* XIII, 1, February 1998, pp. 123-131.

The needed marketing orientation may be manifest as BPR find themselves competing more actively for deposits, as their large margins and needs for economy of scale make this desirable. But so far many BPR have refused to compete vigorously for deposits on the basis of price.

The savings and loan cooperatives need to undergo a parallel process to the BPR, though it is hard to assess how far they have to go and what direction they will actually take. Ideally they should reach comparable prudential standards and compete with the BPR on the margin both for deposits and loan clients. This will take an even more radical reorientation on their part than on that of the BPR.

As a first step, attention needs to be paid to the unregistered savings and loan cooperatives and to getting the registered ones to accurately report their activities to their membership and the Ministry. To the extent cooperatives are depository institutions, they present much the same issues as banks, with a more vulnerable clientele. Even now a number fail each year, and the social impact of these failures should be assessed.

The practice of posting annual reports in commercial banks and BPR is quite salutary and I noticed followed by some of the better managed cooperatives.

Islamic Finance

Islamic banking is a growing phenomenon in Indonesia, but its needs and procedures do not differ so dramatically from other intermediaries as to require differences of general approach. I note that BPRS typically use the same reporting forms to Bank Indonesia as other BPR without strain. Obviously, particular legal and regulatory changes are required.

The phenomenon of non-registration and connected prudential risks are proportionally higher for BMTs, than other Savings and Loan Cooperatives, but the issues they pose are similar in kind. However, negative impacts from their failure will affect not only individual households but the various important social and religious institutions with which they are connected.

Bank Indonesia

The Bank Indonesia needs to orient itself for its role under its new Act as the policy maker for small scale lending and lending to small scale business. To do this it needs to pursue a research agenda, or see that it is pursued elsewhere, that monitors the access and use of formal sector finance by SME as well as the health, interaction, and efficiency of the various financial institutions which serve it. This will require a conscious policy of designating sections in the Bank as responsible for this matter and insuring that they have the necessary information and human resources. These require different orientations and skills from the two activities which are to be spun off – the administration of second tier and two step credit programs and bank supervision.

The new organizations responsible for these two functions – whose precise outlines are not yet determined, will have also to develop their structure and resources for their new tasks. In particular, the institutions or institution responsible for second tier credit will have to study how to design their programs so that they are maximally effective in assisting SME. This may mean less concentration on the concessional terms of particular loans and more on policies which will maximize the flow of resources to all small enterprises and allocate the funds to those enterprises who can use them more effectively.

Remedy Shortcomings

There is some consensus that Indonesian Financial Institutions have certain shortcomings:

--Organizational Weakness, both in operating systems and procedures and in the lack of properly trained and oriented cadres.

--Segmentation. Excess funds in part of the system coexist with excess demand elsewhere.

These weaknesses reflect themselves in high arrearages and transaction costs (See Table 2) and in limits on the ability of the financial system as a whole to serve clients, its lack of efficiency and penetration.

The problem differs in degree, between individual firms in each category and between categories of institutions. The solutions suggest themselves in general – upgraded rules and procedures, better accounting hardware and software, human resource development, and linkages or networking which permit funds to flow in the system. These will all be facilitated by the improved prudential supervision and consequently institutional prudential standards which are now planned.

Prudential Improvements

The improvement in prudential standards is likely to be assisted by the new deposit insurance schemes for commercial banks and BPR which are scheduled to be introduced Jan. 1, 2000 – since it will obviously be difficult to insure already impaired banks.[27] Though similar measures are not now planned for cooperatives and LDKP etc. – competitive pressures will probably force them also to raise their prudential standards.

Linkages

Such an improvement in prudential standards is necessary for linking the smaller, financial institutions to one another and to broader financial markets and commercial banks. Once the creditworthiness of these intermediaries can be certified, others may be willing to put money into them. The forms for getting money in and for providing certification are potentially quite varied. Private bodies could rate them or serve as intermediaries or brokers as seems convenient. One alternative is already clear as private BPR form chains which can provide guarantees of quality. Several donors have indicated support for a rating/linking body (as in the Microlinks or Indo-

[27] The implication is that the 45% of BPR which are not healthy will be closed. Since this would represent a radical step, I suspect there will be a strong demand for some sort of recapitalization scheme for salvageable BPR.

BPR program of USAID) – but at the moment Indonesian private investors are naturally hesitant to launch anything new.

Serving the Underserved

More stringent prudential requirements – especially the higher initial capital and professional levels and policy constraints on opening new competitive banks and BPR (reflecting “need and convenience” considerations in US terms) may mean fewer financial institutions and less service to small borrowers. This factor needs to be considered in designing those standards. It is of especial concern when dealing with underserved clientele and regions.

In general, too few financial institutions, except urban commercial banks, seem to compete for loan business in Indonesia. BPR have been less than vigorous in competing for deposits as well, though commercial banks less so.

In general as well, it would seem that improved efficiency and competitiveness among financial institutions would impel them to serve broader and broader strata of areas and regions – and be a far more powerful engine for extending financial services than targeted programs which will be, of necessity, limited in quantity and supply rather than demand driven. Worse, such targeted programs may pre-empt segments of the markets into which efficient and competitive enterprises might enter.

Small and Medium Scale Finance

The foregoing discussion concerns mostly what is usually referred to as microfinance – small loans to enterprises with few employees (USAID says 10 employees and less), and not SME of 50-500 employees.

A considerable literature argues that these SME are a “missing middle” the absence of which handicaps much LDC development, and that are especially discriminated against in the granting of bank credit.[28] This argument is mostly made on comparative grounds (looking at the experience of Japan in particular). It is alleged that these SME in De Soto’s terms pay a high price for their necessary formality – in taxes, regulatory constraints etc. – without the corresponding benefits – bank credit, political influence. There exists limited data in Indonesia that would enable us to test these allegations.[29]

However, since it is clear that the enterprises concerned need volumes of credit only available from commercial banks, the limitations past, but especially present, on the commercial banks would appear to particularly penalize them. The recommendations above for commercial banks would appear particularly relevant for SME. It is also this sector for which formal sector NBFI

[28] Donald R. Snodgrass and Tyler Biggs, *Industrialization and the Small Firm. Patterns and Policies***.** San Francisco, California: International Center for Economic Growth and Harvard Institute for International Development, 1996.

[29] This is, however, what the data of the Asia Foundation supported studies showing the high costs of registering a company etc. would show.

are especially suited. Further, since the SME are big enough to be in the formal sector they are prime targets of trade regulation. On the other hand, the literature from other countries show that they are neither as labor intensive as microbusiness nor as generally efficient as larger scale business.[30] But the absence of empirical detail on the finances of Indonesian small business means we cannot tell if this is the case in Indonesia.

Research Priorities

Six research tasks suggest themselves:

1. There is a need for understanding of the finances and financial needs of SME to see to what extent they have bankable but unmet needs. This will require carefully designed and administered surveys of the business units seeking rough financial data and verifying that data. The IMD Little study of "boreholes" may be a good prototype.[31]

2. There is a need for further study on the functioning of informal credit markets. As argued by P. B. Ghate, such a study could illustrate the functioning of informal financial institutions as well as give indications of the possibilities for reform of formal sector institutions.[32] Some knowledge of informal financial markets would permit us to explore the limits of formal financial institutions. It would permit us to identify the types of financial instruments and transactions (products) for which there is a demand, but which are not currently being provided by formal financial institutions.

3. A study on the impact of prudential rules, especially newly imposed or impending ones, on the provision of financial services to SME would enable us to see the extent to which such regulation impedes such financial services.

4. A survey of the cooperative financial system is a high priority both because of its size and impact and as guidance for its evolving regulation and promotion. In particular, a substudy of the impact of Saving and Loan Cooperative failure should be a priority.

5. A study of financial markets for underserved areas and clienteles will help determine the effects of competition among financial service providers and the obstacles to financial sector development for them.

6. A study of NBFI and particularly their relation to SME finance would seem a high priority.

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[30] I.M.D. Little, Dipak Mazumdar, and John M. Page, Jr., *Small Manufacturing Enterprises: A Comparative Analysis of India and Other Economies*. New York: Oxford University Press, 1987.

[31] Little, op. cit.

[32] P. B. Ghate, *Informal Finance*, Hong Kong: Oxford University Press, 1992.

No separate mention of shariah finance has been made here, because the best way to study shariah institutions will be a part of the broader financial markets in which they compete. In fact, no study of a sector with a significant shariah subsector should ignore them.

Technical Assistance and Training

Technical assistance and training is required at five levels to improve the efficiency of the financial system for SME – policy makers, supervisors, management, staff, and the general public. To be cost-effective, this training and technical assistance needs to be based on careful and systematic training needs assessments (something that seems rarely to be done), to determine precisely what skills and orientations are needed for the functions concerned, but which skills are absent in the relevant population.

Capital Assistance

The financial system is liquid enough so it is hard to argue that capital assistance per se is required. However, the reluctance to lend may be eroded with carefully planned capital assistance incentives – guarantees, refinance, equity shares. Some subsidization to institutions if not borrowers is approved in major national and donor strategies as part of a financial sector development program. Of course, national governments are often willing to subsidize borrowers as well when they have the budget to do so. This is despite the fact that economists almost universally argue that interest subsidies are highly inefficient in theory, largely diverted in practice, and rarely produce much in the way of political support for the government. In fact, when and if program loans are collected they typically produce more opposition than support.

Just as in the case of training and technical assistance careful justification is needed. Capital assistance proposals need to demonstrate a high degree of leverage and additionality.